

CLASSIFICATION **TECHNICAL INFORMATION FOR PRE-ASSESSMENT SURVEY (TIPS)**

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CLASSIFICATION

TECHNICAL INFORMATION FOR PRE-ASSESSMENT SURVEY (TIPS)

PART 1 BACKGROUND

The objective of this document is to provide guidance for performing a Pre-Assessment Survey (PAS) of the company's internal control for classification and evaluating the results.

Generally Accepted Government Auditing Standards require the PAS team to obtain a sufficient understanding of internal control to plan the audit and determine the nature, timing, and extent of tests to be performed.

The guidelines and terms in this document are based on *Assessing Internal Controls in Performance Audits*, GAO/OP-4.1.4, published by the United States General Accounting Office, Office of Policy, September 1990, and the American Institute of Certified Public Accountants Statement on Auditing Standards No. 78.

PART 2 CLASSIFICATION GUIDANCE

19 CFR 141.86(a)(3) states that each invoice of imported merchandise shall set forth a detailed description of the merchandise, including the name by which each item is known, the grade or quality, and the marks, numbers, and symbols under which it is sold by the seller or manufacturer to the trade in the country of exportation, together with the marks and numbers of the packages in which the merchandise is packed.

19 CFR 141.87 states that whenever the classification or appraisement of merchandise depends on the component materials, the invoice shall set forth a breakdown giving the value, weight, or other necessary measurement of each component material in sufficient detail to determine the correct duties.

19 CFR 141.89 states that additional invoice information is required for certain classes of merchandise in order to determine admissibility and merchandise classification.

19 CFR 152.11 requires merchandise to be classified in accordance with the Harmonized Tariff Schedule of the United States (HTSUS) (19 U.S.C. 1202) as interpreted by administrative and judicial rulings.

2.1 EXAMPLES OF RED FLAGS

The following examples are conditions that may indicate a potential problem in classification:

- The company has insufficiently documented, poorly defined, or no internal control for accurately reporting classifications to Customs.
 - ✓ The company does not monitor or interact with the broker on classification issues.
 - ✓ The company relies on one employee to handle classification issues, and there are poor or no management checks or balances over this employee.
- Company import staff lacks knowledge of classification requirements.
- The company offers unreasonable explanations to Customs.
- The company fails to cooperate with or respond to Customs.
- The company has a high turnover of people in key positions.
- Significant variances exist between the importer's data and data submitted to Customs.
- Customs (e.g., import specialist, account manager, compliance measurements, prior audit, other profile information) shows a history of problems with classification.

- The company uses HTSUSs with known or suspected problems as identified by Customs.
- HTSUSs are complex, or merchandise is classified under a broad range of HTSUSs that would require extensive knowledge to classify.
- The company imports a wide variety of merchandise but enters the merchandise under only a few classifications.
- The company's import pattern has changed.
- Competing HTSUSs have a lower duty rate or relaxed admissibility requirements.
- The company has been referred for enforced compliance.

2.2 EXAMPLES OF BEST PRACTICES

- Internal controls over classification:
 - ✓ Are in writing;
 - ✓ Include procedures for monitoring and feedback; and
 - ✓ Are monitored by management.
- One manager is ultimately responsible for control of the Import Department, including proper classification of merchandise. That manager has knowledge of Customs matters and the power to ensure that internal control procedures for imports are established and followed by all company departments.
- Written internal control procedures assign classification duties and tasks to a position rather than a person.
- The company has good interdepartmental communication about Customs matters.
- The company requests binding rulings and consults with Customs import specialists.
- The company conducts and documents periodic reviews of merchandise classification and uses the results to make corrections to entries and changes to its import operations as appropriate.
- The company requires that vendors provide sufficient descriptions of merchandise on invoices to permit proper classification.
- The company requires periodic training for staff responsible for classifying merchandise.
- The company attends Customs informed compliance outreach and seminars or attends Customs-related seminars provided by private vendors regarding classification issues.
- The company maintains a database of classifications for its product line and requires the classification to be shown on invoices.
- The company requires engineers to obtain the classification for a new part from the Import Department before obtaining a purchase order to buy the part.

2.3 EXAMPLES OF DOCUMENTS AND INFORMATION TO REVIEW

- Internal control policies and procedures
- The company's responses to the questionnaire
- Interviews with company staff concerning actual procedures and internal control specific to classification
- Documentation that supports monitoring and verification of established and/or written internal control for classification
- Other documents supporting proper classification, such as invoices, engineering drawings, and other descriptive information
- Headquarters and New York rulings issued to the company and/or rulings issued for identical/similar products imported by the company

- Import specialist team files, including CF 28s and CF 29s issued to the company

PART 3 RISK ASSESSMENT AND INTERNAL CONTROL GUIDANCE

PAS team judgement should be used to determine the type and amount of testing needed to evaluate how effective internal control is and to determine whether there is a sufficient risk to warrant proceeding to Assessment Compliance Testing (ACT).

Using the chart and the guidelines below, determine through limited judgmental testing whether the company's internal control is effective.

To determine the extensiveness of internal control testing, it is necessary to evaluate:

1. **Risk;** and
2. The **internal control** system, by determining whether the controls are in operation, how the controls are applied, how consistently they are applied, and who applies them.

3.1 RISK

A. Preliminary Assessment of Risk

Before any audit work begins at the company the team should make a preliminary assessment of risk (PAR) using information obtained from Customs or publicly available information. The purpose of the PAR is to evaluate identified potential risks to Customs based on analytical reviews of Customs data and other Customs information. This review will identify areas of potential risk and eliminate some areas with insignificant risk. The PAR should be conducted using the form in Attachment 1 to the PAS Audit Program.

Preliminary Assessment of Risk Examples

Example A: Low Risk Assessment

The import specialist identifies four possible HTSUSs that should be used for the products imported by the company. The computer audit specialist (CAS) verifies that the company has used only four HTSUSs during the past fiscal year. The duty rates for each of the four HTSUSs are the same. Compliance measurement rates are acceptable. The import specialist and account manager do not have any concerns. Therefore, the preliminary assessment of risk is low.

Example B: High Risk Assessment

The importer imports \$450 million in fasteners annually. The import specialist advises that misclassifications are a frequent problem in the fastener industry and that the company has not contacted him for classification guidance. In addition, the company uses numerous classifications for its imports. Because problems frequently occur in this industry, the import specialist has had no interaction with the company regarding classification, and the company uses numerous classifications, the preliminary assessment of risk is high.

B. Evaluation of Risk Acceptability

After the audit work begins with the company the team will refine the assessment of risk. After all audit work has been completed the team will determine whether risk is acceptable or unacceptable using the PAS Audit Program as summarized in the following steps.

- Determine what activities pose a significant risk to Customs.
- Test the existence, effectiveness and implementation of internal control and determine if internal control is adequate to control risk.
- Using the results of the internal control review, develop an opinion whether risk is acceptable or unacceptable.

3.2 INTERNAL CONTROL

To evaluate the internal control system:

1. Consider the five components of internal control:
 - Control Environment
 - Risk Assessment
 - Control Activities
 - Information and Communication
 - Monitoring
2. Review relevant Customs and company documents to identify and understand relevant internal control over classification. (Examples of documents and information to review are listed above.)
3. Determine whether the company has established and follows procedures. Review:
 - Documentary evidence of the results of periodic internal control reviews/testing and corrective action implemented.
 - Documentary evidence of communication between the broker and company on classification issues, company testing of broker operations, and verification that the broker followed company instructions.
 - Company-specific rulings and evidence that they are followed.
 - Documentary evidence of intercompany communications to ensure that correct information is provided to Customs.
 - Training records and materials used to educate staff on classification issues.
4. Review written policies and procedures and interview applicable company personnel to complete appropriate sections of the Worksheet for Evaluating Internal Control (WEIC) for Classification in PART 4 of this document. If applicable, include quota, antidumping duties, admissibility requirements, and other classification issues.

Note: The internal control assessment should include steps to:

- Identify and understand internal control

- Determine what is already known about control effectiveness
- Assess the adequacy of internal control design
- Determine whether controls are implemented and effective
- Determine whether transaction processes are documented

3.3 EXTENSIVENESS OF AUDIT SAMPLE TESTS (TESTING LIMIT)

The purpose of limited PAS testing is to take a survey in order to determine the necessity for and extent of substantive tests. In some circumstances, the PAS team may decide that it probably will not be able to form an opinion based on limited PAS testing. In such cases, it may be necessary to proceed immediately to the ACT process. If the PAS team believes that it can form an opinion based on limited PAS testing, it should test the appropriate number of controls and associated transactions using the table below. Tests may be appropriate for various areas below the classification level that will be reported on. For example, the company may import under numerous classifications, but the PAS team may decide that testing may be necessary only for certain classifications or types of imports that have been identified as the primary risks.

Extensiveness of Audit Tests

PAR Level	+	Preliminary Review Internal Control	=	Extensiveness of Audit Test	Testing Limit
High		Weak Adequate Strong		High Moderate to High Low to Moderate	10-20
Moderate		Weak Adequate Strong		Moderate to High Moderate Low	5-15
Low		Weak Adequate Strong		Low to Moderate Low Very Low	1-10

Source: Adapted from *Assessing Internal Controls in Performance Audits*.
Column titled "Testing Limit" reflects Customs test sizes.

Example (Determination of Testing Level)

Based on a review of the profile (Compliance Measurement (CM) rates were high), questionnaire, written procedures, etc., the team concludes that the preliminary risk exposure is moderate.

The company's internal control procedures manual requires the import manager to review every 50th transaction to ensure that the merchandise is correctly classified and to maintain a "Classification Review Log" to document this process. The import manager documents the transactions she reviews, identifies misclassifications, and files corrected entries. The log shows that misclassified items have been corrected in the company's classification database and with Customs. The team concludes that the internal control system over classification is strong.

Using the table above (based on a moderate risk exposure and strong preliminary internal control evaluation), the team concludes that it will test five control items. The team judgmentally selects three items from the "Classification Review Log". The team import specialist verifies that

two classifications were accurate and one incorrect classification had been corrected. The import specialist reviews two additional entries and determines that the classifications were correct. The company's import manager provides evidence that all entries of the incorrectly classified parts had been corrected. The team verifies that the company took action to prevent future misclassification by examining changes to the classification database and by confirming that classifications on subsequent entries were correct.

3.4 EVALUATION OF PRE-ASSESSMENT SURVEY TESTING RESULTS

The following steps are guidance for determining the effectiveness of company's internal control over classification.

1. Complete the Worksheet for Evaluating Internal Control for Classification to determine whether risk is acceptable or unacceptable and document why. Put the results of testing in perspective and evaluate confirmed weakness as a whole. The evaluation should consider the results of the internal control testing, problems identified in the profile, and/or concerns raised by the import specialist and account manager. The team must evaluate the PAS results based on the specific situation(s).
2. Obtain the PAS import specialist's opinion of the adequacy of controls and the significance of weaknesses identified. Existing guidelines should be used when contacting national import specialists if their assistance is needed.
3. The following will help the PAS team determine whether conditions warrant proceeding to ACT:

Do not proceed to ACT if:

- Cost-benefit analysis warrants no further effort, (do not spend a significant amount of resources to identify a potential loss of revenue considered insignificant.) and
- The result of review indicated that the classification error was due to an isolated incident.
- If substantive tests necessary to determine a compliance rate or revenue loss can be performed quickly and without extensive effort, the team should immediately perform the substantive tests without proceeding to ACT.

Proceed to ACT if:

- The company does not have an adequate internal control and the review indicated a material loss of revenue that cannot be quantified without statistical sampling or further review.
- The importer will not quantify the loss of revenue.
- The company refuses to take corrective action on systemic errors and it is necessary to calculate a compliance rate to evidence significant non-compliance.

Note: If substantive tests necessary to determine a compliance rate or revenue loss can be performed quickly and without extensive effort, the team should immediately perform the substantive tests without proceeding to ACT.

4. Determine whether referrals should be made for enforcement action.

3.5 EXAMPLES

The following examples of situations that might be encountered under the PAS are for clarification only:

Example A: Situation in which the team would not proceed to ACT (Revenue)

The company's written procedures require the Customs Department to provide the broker with specific information (specification sheets, rulings, and complete descriptions) for use in classifying merchandise. The company is required to randomly test X percent of broker-filed entries each month to determine whether classifications were correct and to notify the broker by email if corrections are needed. The broker is required to send the company copies of corrected CF 7501s.

The team:

- Determines that 20 items should be tested, based on:
 - ✓ The high preliminary risk exposure level (Congressional interest in import commodity and import specialist concerns).
 - ✓ The adequate preliminary internal control evaluation (there was no procedure to monitor broker corrections).
- Reviews the company's "Classification Audit Log" to verify that the company had tested X percent of the entries during the past few months.
- Identifies five misclassifications that the company had asked the broker to correct and verifies that the broker had corrected the classification but had not notified the company of the correction.
- Selects several entry summaries, judgmentally selects 15 line items, and confirms that classifications were correct.

The company agrees that the import manager will monitor the broker's corrections in the future. The team concludes that proceeding to ACT will not be necessary because:

- The PAS team has verified classifications were corrected and did not result in unpaid duty.
- The company has elevated its monitoring of the broker to a management level.

Example B: Situation in which the team would not proceed to ACT (Compliance)

The team does not identify any concerns in the questionnaire, profile, or interviews. The company has implemented its written internal control procedures, which:

- Assign the company's in-house broker the responsibility for classifying imported merchandise
- Require the import manager to review/test classifications used during the month
- Require the import manager to periodically communicate with and train other departments, such as Engineering and Purchasing, on classification requirements

The team concludes that the preliminary risk exposure is low and internal control is strong. The team judgmentally tests four classifications and finds the merchandise is properly classified. Since internal control was implemented and effective and no incorrect classifications are found, the team concludes that there are no unacceptable risk areas and does not proceed to ACT compliance testing.

Example C: Situation in which the team would proceed to ACT for (Revenue)

The team finds the same situations as identified in example B. However, the import specialist determines that the classifications tested were not correct and there was a significant loss of revenue on a number of items. The team proceeds to ACT to determine loss of revenue.

Example D: Situation in which the team would proceed to ACT (Compliance)

In the same situation as example A above, the company stopped reviewing the broker's classifications 2 years before, when a new import manager was hired. PAS testing of 20 classifications shows that three were incorrect. The PAS team considers the breakdown in the company's control system significant enough to proceed to the ACT process to quantify the level of noncompliance.

PART 4 WORKSHEET FOR EVALUATING INTERNAL CONTROL (WEIC) - CLASSIFICATION

PURPOSE: To determine whether Classification risk is acceptable.

The completion of this worksheet provides evidence that the five components of internal control: Control Environment, Risk Assessment, Control Activities, Information and Communications, and Monitoring were evaluated.

During this phase of the process, an internal control review will be completed and factors for internal control related to an assessment of Risk Exposure including Internal Control Red Flags, Susceptibility, Management Support and Competent Personnel will be considered. The completion of this worksheet provides evidence that these factors were evaluated.

All answers must be linked to supporting documentation.

OBJECTIVES:

Section 1 - Internal Control Questions	Consolidate information learned about internal control through interviews and document reviews to form a preliminary assessment of internal control before testing. For work paper reference column titled "Is Implementation of Control Supported by Documentation and/or Interviews," confirm that the control is implemented through: <ul style="list-style-type: none"> • Interviews and requesting evidence from the company and • Reviews of documents that provide evidence that the company completed the activity.
Section 2 - Preliminary Internal Control Assessment	Use information consolidated in Section 1 to make a preliminary assessment whether internal control is strong, adequate, weak or nonexistent.
Section 3 - Sample sizes	Use the Preliminary Assessment of Risk (PAR) Level and the Preliminary Internal Control Assessment to determine the sample size for each sample.
Section 4 - Results of Sample Testing	Use information in Section 4 to record the results of PAS testing to evaluate whether internal control is effective to provide reasonable assurance of compliance.
Section 5 - Risk Opinion	Use information in section 1-4 to record the PAS opinion that risk is acceptable or unacceptable

Section 1 – Internal Control Questions

No.	Internal Control (IC)	Yes	No	Work Paper Reference		Comments
				IC Manual Page Number	Is Implementation of Control Supported by Documentation and/or Interviews?	
1.	Does the company have formally documented internal control to assure that classification is correctly declared?					
2.	Does management approve written policies and procedures?					
3.	Does the company review and update written policies and procedures periodically?					
4.	Is internal control over classification periodically tested and results documented? (This should include post-entry reviews to verify correctness of classification.)					
5.	If the company found weaknesses during internal control testing of classification, did the company correct internal control procedures and entries when appropriate?					
6.	Do written internal control procedures assign classification of merchandise to a position rather than an individual?					

No.	Internal Control (IC)	Yes	No	Work Paper Reference		Comments
				IC Manual Page Number	Is Implementation of Control Supported by Documentation and/or Interviews?	
7.	Does one individual have authority to ensure that internal control procedures for classification of imports are established and followed by all company departments?					
8.	Do personnel responsible for classifying merchandise have adequate knowledge and training in classification?					
9.	Does the company have adequate interdepartmental communication about classification?					
10.	Does the company have procedures to request Customs assistance classifying merchandise when needed and is advice followed when given (e.g., requesting binding rulings)?					
11.	Does the company identify, analyze, and manage risks related to classification?					
12.	Has the company identified any risks related to classification and implemented control mechanisms?					

No.	Internal Control (IC)	Yes	No	Work Paper Reference		Comments
				IC Manual Page Number	Is Implementation of Control Supported by Documentation and/or Interviews?	
13.	Do suppliers, engineers, the purchasing department, laboratory and others provide adequate descriptive information to the Import Department to ensure proper classification?					
14.	Does the company have policies and procedures in place to ensure the proper classification of new items?					
15.	Does the company maintain product classifications in a database that is provided to brokers and updated when necessary?					
16.	If the company provides the broker with the classification is the broker required to obtain company concurrence prior to making classification changes?					
17.	Does the company provide adequate broker oversight of classification issues?					
18.	List company-specific procedures below (if applicable)					

Section 2 - Preliminary Internal Control Assessment

Use information obtained in section 1 above to make a preliminary assessment of internal control as strong, adequate, weak, or nonexistent.

	Strong	Adequate	Weak	None*
Internal Control				

* If the team concludes that the company does not have internal control, risk is not acceptable so proceed to Section 5 below.

Section 3 – Sample Sizes

Use the matrix for determining Extensiveness of Audit Tests in section 3.3 of TIPS to determine the extensiveness of audit tests to confirm that internal control is effective. Multiple samples are possible. Samples and sample items should concentrate on risk.

Sample Area	PAR Risk Level (High, Moderate, or Low)	Internal Control Level (Weak, Adequate, or Strong) From Section 2 Above	Testing Limit (1-20)

Section 4 - Results of Sample Testing

Use the results of sample testing to determine if internal control is effective.

Results of Testing	Yes or No
Is IC effective to provide reasonable assurance to preclude significant risk?	

Section 5 - Risk Opinion

Use the information developed in Sections 1-4 to record the PAS opinion that risk is acceptable or unacceptable.

Risk Opinion	Yes or No	Comments
Acceptable		

If risk is not acceptable the audit team may need to proceed to ACT or have company do quantification.